Office of Chief Counsel
Internal Revenue Service

memorandum

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date: April 22, 1999

to: Chief, Examination Division, Connecticut-Rhode Island District
Attn: [redacted], Case Manager , [redacted]

from: District Counsel, Connecticut-Rhode Island District, E. Hartford

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subject: [redacted]
Mortgage Arbitrage Partnership- [redacted] & [redacted]

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

This responds to your request for our advice concerning whether during the current cycle ([redacted] & [redacted]), the Service can examine and make adjustments to certain partnership items that were previously examined and for which the Service issued a "no change" letter for the [redacted] taxable year.

As orally discussed with Case Manager [redacted], based on the facts presented, we conclude that the Service can examine and make adjustments to the partnership items.

FACTS:[1/]

In [redacted], [redacted], ([redacted]), a CEP taxpayer, possessed approximately $[redacted] in capital loss carryovers which were due to expire on [redacted]. In an attempt to offset the losses, [redacted], with the assistance of [redacted], purchased a [redacted]% interest in [redacted], a limited partnership (the taxpayer), whose stated purpose was to accelerate the recognition of capital gain during [redacted] and, thereafter, generate ordinary or capital losses for its partners.

Consistent with this purpose, during [redacted], the taxpayer sold the gain leg of a [redacted] straddle transaction generating a capital gain to [redacted] of $[redacted], which [redacted] then used to fully offset the $[redacted] losses on its [redacted] return. It is apparent that [redacted] paid [redacted] $[redacted] for its role in structuring the transaction.

From [redacted] to [redacted], the partnership reported ordinary losses totaling $[redacted]. The Service audited the [redacted] partnership return under the TEFRA proceedings, reviewed the transaction, and thereafter, issued the taxpayer a "no change" letter. Our understanding is that the Service has never audited the taxpayer's [redacted], [redacted] and [redacted] partnership returns and that the statute of limitations for those years have expired. Furthermore, the Service did not audit [redacted]'s [redacted] through [redacted] income tax returns.

The Financial Product Specialist (FPS) is presently examining both the taxpayer's and [redacted]'s [redacted] and [redacted] returns, and is considering disallowing the losses reported on these returns because he believes the transaction lacks economic substance and, is therefore, a sham. Although neither the taxpayer nor [redacted] submitted a written protest, our understanding is that both contend that the Service's review and acceptance of the transaction for the [redacted] taxable year precludes it from reexamining the transaction for [redacted] and [redacted]. You requested our opinion as to whether this contention is correct.

[1/] The facts recited herein relate solely to the procedural issue as to whether the Service's review and issuance of the "no change" letter for the [redacted] taxable year precludes it from examining the transaction for the [redacted] and [redacted] taxable years. We have not been provided the factual information regarding the question as to whether the transaction lacks economic substance.

LAW AND ARGUMENT:

Although not precisely articulated, the taxpayer and Hubbell appear to premise their argument on an estoppel theory - that somehow, the Service's previous review and issuance of the "no change" letter[2/] preclude it from reexamining the same transaction on the [redacted] and [redacted] returns. The courts, however, repeatedly reject this argument. It is well established that the acceptance of a prior return does not estop the Service from raising the same issue in a later return. Moreover, each tax year stands on its own, and the Service can challenge in a succeeding year what it condone or agreed to in a prior year. See Harrah's Club v. United States, 661 F.2d 203 (Ct. Cl. 1981) (holding that the Service was not estopped from disallowing as depreciation deductions in subsequent years the taxpayer's costs of restoring antique automobiles, even though it entered into a settlement with the taxpayer in previous years agreeing that the costs could be depreciated); Caldwell v. Commissioner, 202 F.2d 112 (2d Cir. 1953) (holding that the Service was not estopped from challenging in a later year the method of income used by the taxpayer, even though it previously examined and raised no question regarding this method in previous years); Ekren v. Commissioner, T.C. Memo. 1986-509 (holding that the Service's audit and acceptance of the taxpayer's position that she was not subject to employment tax in previous years did not prevent the Service from asserting that she was subject to employment tax for the same business activity in a subsequent year). The rationale behind this policy is that if errors are made in previous years, they are not to be perpetrated in the taxable years involved. Engineers Ltd. Pipeline Co. v. Commissioner, 44 T.C. 226 (1965).

Obviously, absent fraud, the statute of limitations bars the Service from disallowing or redetermining the partnership items of the taxpayer for [redacted] through [redacted]. In this regard, our understanding is that the FPS anticipates limiting any proposed adjustments solely to the open years of [redacted], [redacted] and possibly [redacted].

Undoubtedly, the [redacted] and [redacted] losses precipitate from the structure of the transaction which began in [redacted]. However, even though the Service previously failed to disallow the transaction, the authority recited above clearly entitles the FPS to disallow for any valid reason the losses claimed by the taxpayer on the [redacted] and [redacted] returns. Further, even though he is unable to

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[2/] To date, it remains uncertain as to whether the Service issued the "no change" letter because it accepted the transaction as reported on the [redacted] return or for some other reason.

disallow the capital gain and/or the losses reported on the taxpayer's [redacted] through [redacted] returns, he is entitled to review the taxpayer's and third parties' books and records in order to determine the correctness of the [redacted] and [redacted] losses. Therefore, in determining whether the [redacted] and [redacted] losses lacked economic substance, the FPS is entitled to review the previous returns and any documentation which shed light on the correctness of the losses.

Furthermore, it is clear that the "no change" letter neither constitutes a closing agreement under I.R.C. § 7121 nor an offer in compromise under I.R.C. § 7122, thus, binding the Service to accept the transaction.

Finally, although not argued, clearly the audit of the [redacted] and [redacted] returns do not constitute a "second examination" under I.R.C. § 7605(b) since these years were never previously examined.

CONCLUSION

In summary, based on the facts presented herein, we have found no legal authority supporting the taxpayer's position that the Service is precluded from examining the [redacted] and [redacted] losses. We note that we do not opine on the substantive issue as to whether the transaction lacked economic substance. However, if necessary, we remain available to assist the FPS in developing this issue.

Further, this opinion is based on the facts set forth herein. Should you determine that they are different, you should not rely on this opinion without concurring with this office. Further, this opinion is subject to ten day post-review procedure in our National Office. That review might result in modifications to the conclusions herein. Should our National Office suggest any material change in the advice, we will inform you as soon as we hear from that office.

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By: _____
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